No. 80-715

FIL
DEC 1
MICHAEL RODAK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

UNITED GAS PIPE LINE COMPANY,
Petitioner,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

BRIEF OF THE PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK, UNITED MUNICIPAL DISTRIBUTORS GROUP, AND LACLEDE GAS COMPANY IN OPPOSITION

Peter H. Schiff, Esquire
General Counsel
Public Service Commission of the
State of New York
Empire State Plaza
Albany, New York 12223

Richard A. Solomon, Esquire
Barry A. Friedman, Esquire
Wilner & Scheiner
1200 New Hampshire Avenue, N.W.
Suite 300
Washington, D.C. 20036
(202) 861-7830

Attorneys for the Public Service
Commission of the State of New York

William T. Miller, Esquire
Stanley W. Balis, Esquire
Miller, Balis & O'Neil, P.C.
776 Executive Building
1030 Fifteenth Street, N.W.
Washington, D.C. 20005
(202) 789-1450

Attorneys for United Municipal
Distributors Group

J. David Mann, Esquire
Kevin P. Gallen, Esquire
Morgan, Lewis & Bockius
1800 M Street, N.W.
Washington, D.C. 20036
(202) 872-5010

Attorneys for Laclede Gas Company

QUESTIONS PRESENTED

Whether the Federal Energy Regulatory Commission in establishing the fair rate of return for United Gas Pipe Line Company (United) properly assigned a net cost of zero to the preferred stock component of United's capital structure in light of the fact that all dividends paid on this preferred stock during the periods the rates were in effect had been returned to United.

PARTIES TO THE PROCEEDING

The parties to the proceeding in the United States Court of Appeals for the Fifth Circuit, whose judgment is sought to be reviewed, are: United, Laclede Gas Company, Public Service Commission of the State of New York, United Municipal Distributors Group, and the Federal Energy Regulatory Commission (Commission or FERC).

TABLE OF CONTENTS

PAGE

Question Presented i

Parties to the Proceeding i

Table of Authorities iii

Opinion Below 1

Jurisdiction 2

Statement of the Case 3

Argument 6

Conclusion 11

TABLE OF AUTHORITIES

PAGE

CASES

FPC v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944) 7, 8

Powell v. *Washington Metropolitan Area Transit Commission*, 485 F.2d 1080 (D.C. Cir. 1973) 10

STATUTES

Natural Gas Act, 15 U.S.C. 717, *et seq.* 6

Section 14(a), 15 U.S.C. 717m(a) 3
Section 19(b), 15 U.S.C. 717r(b) 2

28 U.S.C. 1254(i) 2

AGENCY OPINIONS

United Gas Pipe Line Company, Opinion No. 815-A, Docket No. RP74-20, *et al.* November 15, 1977 4

United Gas Pipe Line Company, Opinion No. 16, Docket No. RP75-30 (July 3, 1978) 5

No. 80-715

IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

UNITED GAS PIPE LINE COMPANY,
Petitioner,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

BRIEF OF THE PUBLIC SERVICE COMMISSION OF
THE STATE OF NEW YORK,
UNITED MUNICIPAL DISTRIBUTORS GROUP,
AND LACLEDE GAS COMPANY IN OPPOSITION

OPINION BELOW

The opinion of the Court of Appeals (Pet. App. A-1-A-26) is reported at 618 F.2d 1127. The order of the court

denying rehearing (Pet. App. B) is not reported. The opinion and order of the Federal Energy Regulatory Commission (Pet. App. C-1-C-28), and its Order Denying Rehearing (Pet. App. D) are not yet reported.

JURISDICTION

The judgment of the court of appeals was entered on June 12, 1980. A petition for rehearing was denied on July 30, 1980. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(i) and Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

STATEMENT OF THE CASE

Prior to March 14, 1974, Petitioner existed as a wholly owned subsidiary of the Pennzoil Company (Pennzoil), a diversified corporation operating principally in the energy and natural resources fields. On that day, however, Pennzoil effected a plan whereby the regulated pipeline subsidiary, United, was divorced from the other Pennzoil enterprises. The "spin-off" was accomplished by awarding each Pennzoil shareholder three-tenths of a share of United common stock for each share of stock owned in Pennzoil.

While the "spin-off" untied the legal connection between Petitioner and Pennzoil, it created some very strong, new economic ties between them. Just prior to

March 14, 1974, United converted $100 million of its earned surplus into one million shares of 9-3/4% cumulative preferred stock, which were then issued to its parent and sole shareholder, Pennzoil, as a "dividend." Further, Pennzoil agreed to forego $10 million of existing and future United liabilities and to forgive $5 million of United's 1974 federal corporate income tax liability. This $15 million was then shifted on United's books from a liability to earned surplus.

The Federal Power Commission,[1] reacting to the "spin-off" transaction, ordered an investigation pursuant to its authority under Section 14 of the Natural Gas Act, 15 U.S.C. § 717m. The Commission's expressed concerns in that proceeding, Docket No. RP74-87, included, *inter alia,* whether the "spin-off" would adversely affect United's financial posture and alter its continued ability to adequately serve the natural gas needs of its customers.

The spin-off investigation led to hearings and finally to settlement negotiations. The settlement agreement, as ultimately reached on July 11, 1975, provided, *inter alia,* that:

---

[1]Pursuant to the Department of Energy Organization Act of 1977, the Federal Power Commission ceased to exist on October 1, 1977, and most of its regulatory responsibilities were transferred to the newly created Federal Energy Regulatory Commission. Both are referred to herein as the Commission.

1. The preferred stock would be cancelled and all dividends paid to Pennzoil returned to United.
2. The $15 million in cancelled liabilities and forgiven taxes would be returned to Pennzoil.
3. Pennzoil would grant United a right of first refusal to production from certain Pennzoil natural gas reserves.

The settlement was approved, as proposed, by the Commisison on November 28, 1975, and the required financial transactions took place on December 30, 1975.

During the period that the original "spin-off" transactions were in effect, United had a number of rate increase proceedings pending before the Commisison in which the appropriate rate of return was an issue. The question as to the appropriate capital structure for determining rate of return in the light of the "spin-off" and subsequent settlement was initially raised in Docket No. RP75-30. The Commission, on motions by Laclede and New York, subsequently consolidated the rate of return issue in two previous dockets, i.e., Nos. RP74-20 and RP74-83, with Docket No. RP75-30 for resolution.[2]

In his Initial Decision in Docket No. RP75-30, the Presiding Administrative Law Judge focused squarely on how to treat the $100 million of cumulative preferred stock in determing the pipeline's just and reasonable rate of return. He correctly reasoned that during the locked-in period in question, the $100 million was carried on United books and records as preferred stock

---

[2]United Gas Pipe Line Company, Opinion No. 815-A, Docket Nos. RP74-20, *et al.* (November 15, 1977).

and treated by United as preferred stock rather than common equity capital, and that it should therefore be treated as preferred stock for ratemaking purposes. Moreover, inasmuch as United had already received back all of the dividends it had paid to Pennzoil with respect to this stock, he concluded that the actual embedded cost of this preferred stock to United was zero and that to allow United a 9-3/4% return on this portion of its capital structure would give United an unacceptable double recovery, i.e., once from Pennzoil and again from United's customers. Finally, since United's equity level during the locked-in period was unusually low, at 22.92%, a 15% rate of return on common equity was held to be justified.

The Commission, in Opinion No. 16,[3] unanimously affirmed the Initial Decision. The Commission concluded that since all of the dividends were returned by Pennzoil to United, the preferred stock was cost-free to United. Although the Initial Decision had not done so, the Commisison included in United's common equity the approximately $15 million in capital contributions from Pennzoil to United which were in existence during the locked-in period. While this had the effect of increasing United's equity ratio, the Commission still permitted United to obtain the 15% return on common equity fixed in the Initial Decision.

On June 12, 1980, the court of appeals unanimously affirmed (Pet. App. A-1 - A-26). It found that the "unusual circumstances" involved in this case provided

---

[3]United Gas Pipe Line Company, Docket No. RP75-30, (July 3, 1978) (Pet. App. C).

a sufficient basis to justify the Commission's treatment of the $100 million in preferred stock as cost-free to United, while still allowing that pipeline to meet its expenses and offer a satisfactory return to common equity holders. On July 30, 1980 the court of appeals denied United's petition for rehearing (Pet. App. D).

ARGUMENT

The present petition presents a case book example of the type of situation in which review by this Court would not be warranted even if the discrete legal issue involved were as substantial as the petitioner has alleged it to be. The court below fully considered and correctly decided the issues raised in this case. There is no conflict between the circuits. The Commission's opinion was unanimous, as was the affirmance by the court below, and does not involve any significant issue of law or policy in the continuing administration of the Natural Gas Act, 15 U.S.C. §§ 717, *et seq.* Moreover, while the Commission's decision resulted in a lower overall rate of return than petitioner originally sought, there is no claim that the effect of the lower return for a limited past period impaired United's financial well being or its ability to provide adequate service to its customers.

The Commission merely followed its normal practice of treating preferred stock like debt for rate of return purposes by costing it at its embedded cost to the pipeline. In this case, that embedded cost was zero. United's principal argument for granting the writ is misplaced in that it is addressed solely to the standards to be utilized in setting the return on common equity, not on preferred stock; however, the $100 million of

capital in question was properly classified as preferred stock during the entire locked-in period in question. As noted above, the Commission granted United a most generous 15% return on its common equity and that return on the relatively low percentage of United's capitalization which was comprised of common equity has not been challenged either before this Court or the court below.

United's claim is essentially that, since the $100 million was originally earned surplus, it somehow has an inalienable right to receive more from its customers than the actual embedded cost of the preferred stock. However, United voluntarily converted this $100 million of earned surplus into preferred stock. Moreover, United itself treated this $100 million as preferred stock during the period in question, and the actual cost incurred by United with respect to this portion of its capitalization was zero, since the payments made to Pennzoil during this period were later returned to United pursuant to the spin-off settlement. United would now have this Court treat the original spin-off as if it never occurred and reward United's stockholders with additional earnings, over and above those to which they would otherwise have been entitled during the locked-in period. This is not the law, as enunciated by this Court.

In *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944), this Court made clear that:

> . . . the Commission was not bound to the use of any single formula or combination of formulae in determining rates. Its rate making

> function, moreover involves the making of 'pragmatic adjustments.' And when the Commission's order is challenged in the courts, the question is whether that order 'viewed in its entirety' meets the requriements of the Act. Under the statutory standard of 'just and reasonable' it is the result reached not the method employed which is controlling. It is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at end. (Citations omitted).

Hope also established the parameters for the Commission's determination of the return portion of a pipeline's rates (320 U.S. at 603):

> [T]he investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should

> be sufficient to assure confidence in the financial integrity of the enterprise so as to maintain its credit and to attract capital. The conditions under which more or less might be allowed are not important here . . . . Nor is it important to this case to determine the various permissible ways in which any rate base upon which the return is computed might be arrived at. (Citations omitted).

Under these standards, the Commission's decision, affirmed by the court below, cannot conceivably be characterized as "unjust and unreasonable." The Commission took note of the fact that during the period the preferred stock was outstanding the pipeline's ratio of common equity captial was artificially lowered and therefore provided United's common stockholders with a 15% rate of return on common equity, far higher than any equity return allowed any other pipeline during the period in question or than would have been appropriate if the $100 million in preferred stock had been part of common equity capital. (For the periods since the preferred stock was cancelled, the return on equity incorporated into United's approved rates has been substantially below 15%). There has been no claim that the return on common equity the Commission allowed during the spin-off period was any less than that to which United's stockholders would have been entitled if the preferred stock had remained

outstanding.[4] And, of course, the financial position of United and its common stockholders is far superior to that which would have existed if the approximately $15 million in dividends paid to Pennzoil had not been returned as a result of the Commission's order in the spin-off settlement proceedings.

The simple fact is that United benefited greatly in terms of both financial strength and gas supply from the Commission's order which restructured the spin-off transactions at the completion of the spin-off investigation. Now United is claiming that the Commission was additionally required to afford United's stockholders a higher return for the period when the original spin-off transaction was in effect than they would have had a right to claim in the absence of the Commission order. Any such claim was and is without merit. While United may not be quite in the position of the proverbial patricide who sought the court's mercy as an orphan, it certainly is no Oliver Twist whose request for more is entitled to the sympathy or the intervention of this Court.

---

[4]Petitioner's reference to *Powell* v. *Washington Metropolitan Area Transit Commission*, 485 F.2d 1080 (D.C. Cir. 1973), for the proposition that the Commission confiscated United's assets is misplaced. In that case, a bus line customer challenged a regulatory agency's allowance of a rate of return on retained earnings placed into common equity. The Commission ruled that equity left in the business served to strengthen the firm's capitalization and was deserving of a return. Here, of course, United took retained earnings and transferred them into a "quasi-debt," preferred stock, the return on which is computed by examining its embedded cost.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

Peter H. Schiff, Esquire
General Counsel
Public Service Commission of the
State of New York
Empire State Plaza
Albany, New York 12223

Richard A. Solomon, Esquire
Barry A. Friedman, Esquire
Wilner & Scheiner
Suite 300
1200 New Hampshire Avenue, N.W.
Washington, D.C. 20036
(202) 861-7830

Attorneys for the Public Service
Commission of the State of New York

William T. Miller, Esquire
Stanley W. Balis, Esquire
Miller, Balis & O'Neil, P.C.
776 Executive Building
1030 Fifteenth Street, N.W.
Washington, D.C. 20005
(202) 789-1450

Attorneys for the United Municipal
Distributors Group

J. David Mann, Jr., Esquire
Kevin P. Gallen, Esquire
Morgan, Lewis & Bockius
1800 M Street, N.W.
Washington, D.C. 20036
(202) 872-5010

Attorneys for Laclede Gas Company

Dated: December 1, 1980